

THE IMPACT OF HEDGING ON DAMAGES IN OIL, COMMODITY AND SHIPPING CASES

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Source:

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THE IMPACT OF HEDGING ON DAMAGES



HEDGING HAS HAD A BAD PRESS AND IN MY EXPERIENCE IS MUCH MISUNDERSTOOD

EFFECTIVE HEDGING IS NOT

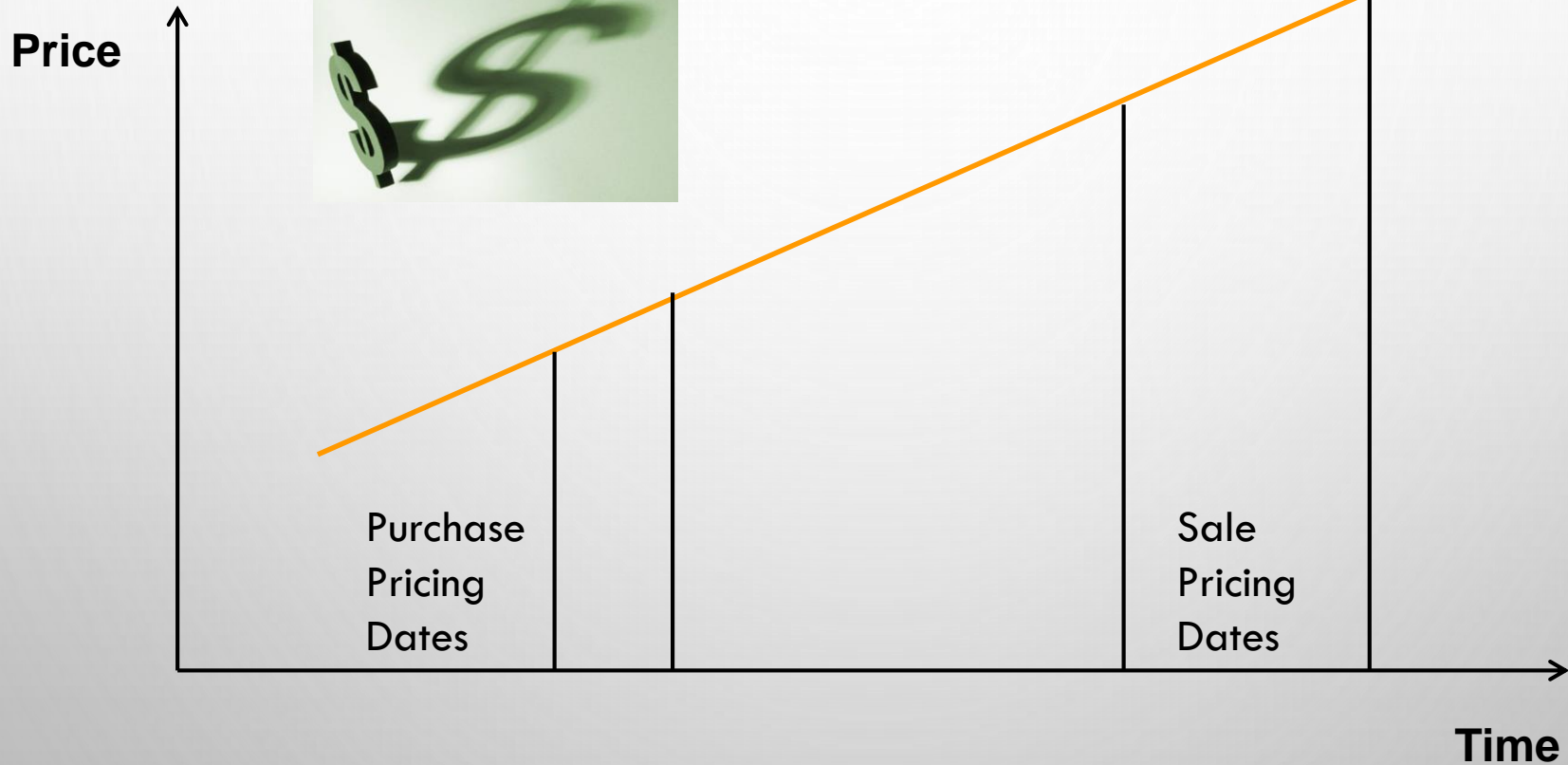
- ❖ BETTING
- ❖ RISKY
- ❖ RECKLESS
- ❖ SPECULATIVE
- ❖ SEPARATE FROM PHYSICAL COMMODITY PRICE RISK

My favorite film – Trading Places – demonstrates how speculating on the futures market can bring incredible financial rewards, especially if one trades on the back of “Fake News”! It led to the “Eddie Murphy Rule” forming part of the Dodd Frank Wall Street Reforms in 2010



BUT I AM TALKING ABOUT HEDGING NOT SPECULATING

A TRADER HOPES THAT EVERY CARGO WILL MAKE HIM MONEY – BUY LOW SELL HIGH!



BUT HE COULD FACE A LOSS IF THE MARKET MOVES AGAINST HIM

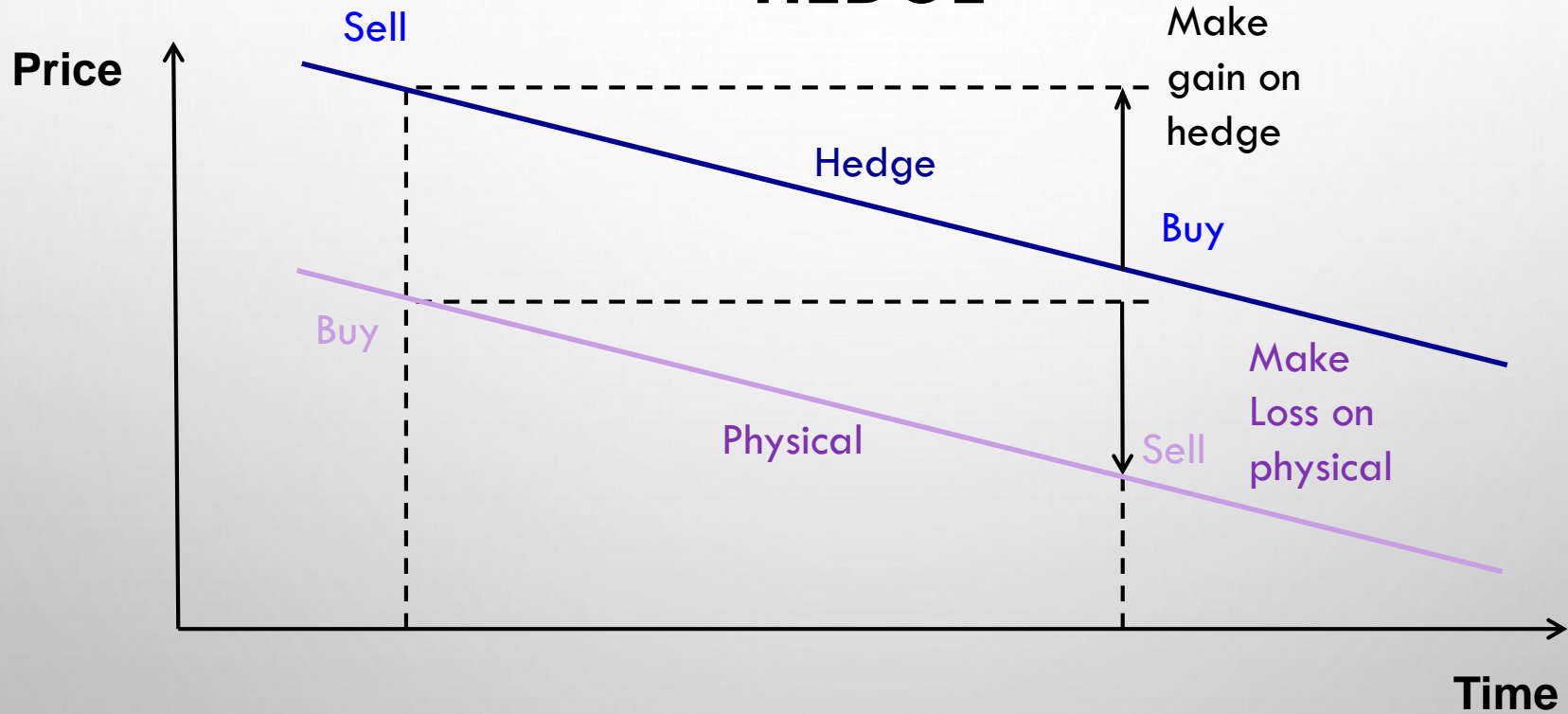


HEDGE PRINCIPLES ARE TO TAKE AN EQUAL AND OPPOSITE POSITION IN THE HEDGE TO THE PHYSICAL

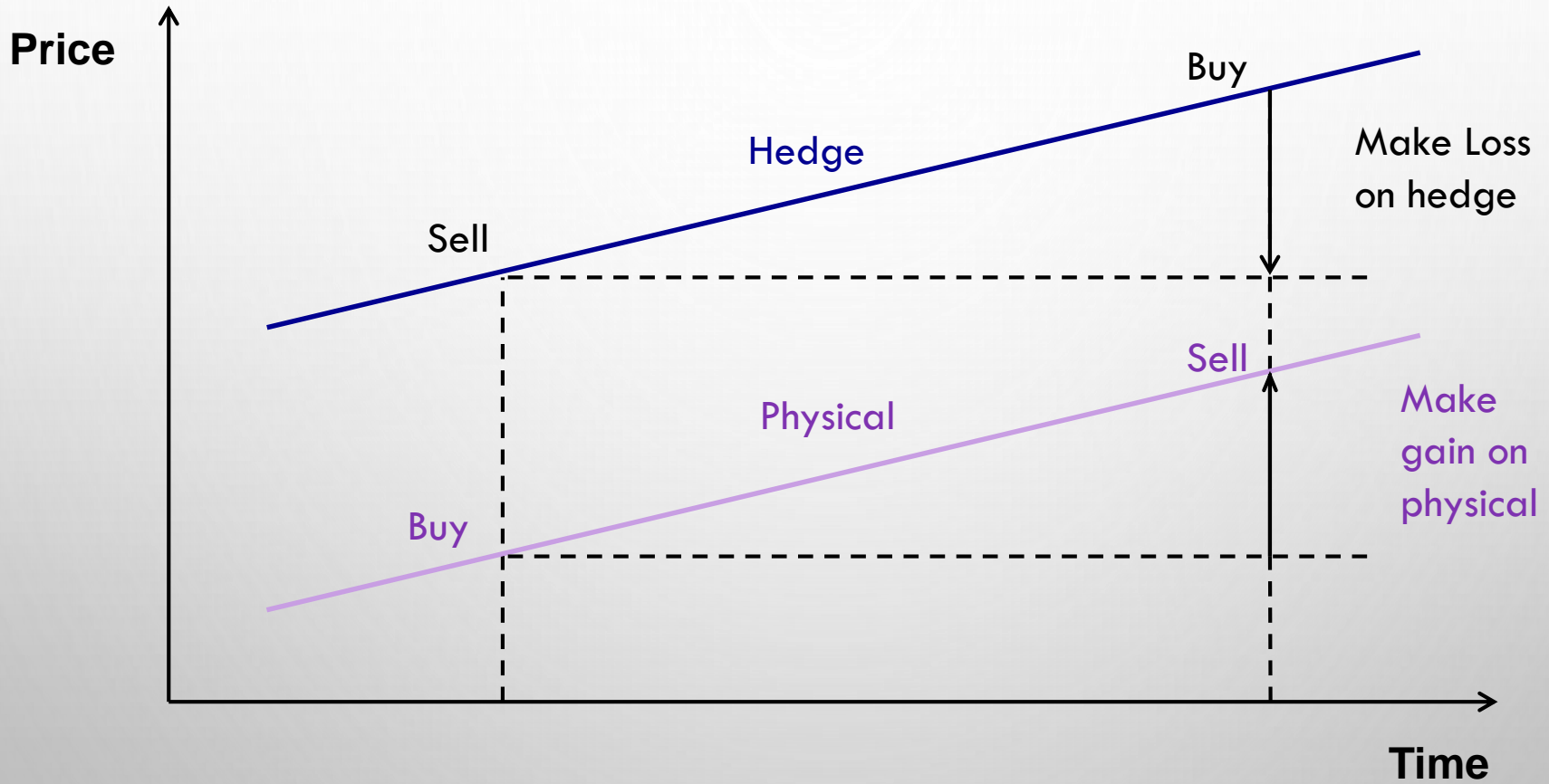
- WHAT A HEDGER GAINS ON THE ROUNDABOUT IS LOST ON THE SWINGS (IN A PERFECT HEDGE.....)
- OFTEN REFERRED TO AS LOCKING IN A PROFIT
- BUT A HEDGE CAN BECOME SPECULATIVE IF IT IS NO LONGER LINKED TO A PHYSICAL POSITION LONG OR SHORT



THE IDEA OF THE HEDGE IS IF YOU LOSE MONEY ON YOUR PHYSICAL YOU MAKE MONEY ON YOUR HEDGE



BUT A HEDGE ALSO MEANS YOU LOSE MONEY ON HEDGE IF YOU GAIN ON YOUR PHYSICAL



ANY CLAIM ASSOCIATED WITH A CHANGE IN THE VALUE OF A COMMODITY MAY BE REDUCED OR INCREASED BY HEDGING

- PIRATE ATTACK
- OWNER REFUSES
- CONTAMINATION
- NON PERFORMANCE
- DELAY ON LOADING OR DELIVERY

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DOCUMENTS

BECAUSE HEDGING CAN SUBSTANTIALLY INCREASE OR DECREASE QUANTUM, ISSUES AROUND HEDGING SHOULD BE CONSIDERED EARLY IN DISPUTES

- FORESEEABILITY/EXCLUSION/CAUSATION/REMOTENESS
- MITIGATION
- INSURANCE OVERPAY
- SETTLEMENT

A FEW REPORTED DECISIONS CLARIFY THE TREATMENT OF HEDGING LOSSES AND GAINS WHERE BOTH PARTIES ARE TRADERS

- GLENCORE V TRANSWORLD DEMONSTRATED THE IMPORTANCE OF MITIGATING USING HEDGING TO DAMAGE CLAIMS UNDER CONTRACTS FOR COMMODITY SALES
- ADDAX V ARCADIA FOUND THAT BOTH PARTIES WERE SOPHISTICATED OIL TRADERS AND THEREFORE FORESEEABILITY OF HEDGING WAS NOT AN ISSUE
- CHOIL V SAHARA CONFIRMED HEDGING LOSSES ARE CLAIMABLE, EVEN IF THE PHYSICAL OIL HAS INCREASED IN VALUE, AND ARE NOT NECESSARILY EXCLUDED BY EXEMPTION CLAUSE

AND IN MY EXPERIENCE FEW CHALLENGES ARE NOW MADE RE FORESEEABILITY OF HEDGING LOSSES WITH RESPECT TO SHIP OWNERS

HUGELY VOLATILE OIL PRICES MEAN THAT OIL TRADERS ALWAYS CONSIDER WHETHER TO HEDGE

- ASSUME ALL TRADERS CONSIDER HEDGING
- ESTABLISHED COMPANY HEDGING POLICY OFTEN SET BY BOARD. TAKE A LOOK AT COMPANY WEBSITE AND ANNUAL ACCOUNTS
- NO SET STRATEGY TO HEDGE A COMMODITY PRICE RISK BUT REASONABLE TO SELECT HEDGE TO MATCH AS BEST AS POSSIBLE THE PHYSICAL POSITION. HEDGE APPLES WITH APPLES NOT PEARS.
- BUT SOMETIMES BREACHES AND RESULTING AMENDMENTS TO HEDGE MAY CAUSE LOSSES IN HEDGES TO BE HIGHER THAN GAINS IN PHYSICAL

BUT NOT ALL COMPANIES END UP HEDGING, AND MANY DO NOT HEDGE 100%

- EXXON/MIDDLE EASTERN COMPANIES
- LACK OF UNDERSTANDING MEANS MAY CONSIDER IT TO BE RISKY OR SPECULATIVE - IN FACT GENERALLY MORE RISKY NOT TO HEDGE
- DECIDING NOT TO HEDGE IS AS IMPORTANT A DECISION AS TO DECIDE TO HEDGE
- TRADERS MAY HAVE EXPOSURE LIMITS ALLOWING THEM TO TRADE UNHEDGED TO THEIR LIMITS
- FUNDS REQUIRED FOR MARGIN CALLS, NEEDED TO TRADE REGULATED DERIVATIVES, MAY NOT BE AVAILABLE AND FORCE A TRADER TO HEDGE PART RATHER THAN ALL RISK

MANY OIL COMPANIES DO NOT HEDGE INDIVIDUAL DEALS BUT HEDGE GLOBAL RISK ACROSS ALL THEIR TRADING BOOKS

- MAY BE BALANCED ACROSS MARKETS
- MAY TRANSFER HEDGES FROM OTHER STRATEGIES
- HEDGING GLOBAL RISK CAN MAKE IT IMPOSSIBLE TO IDENTIFY INDIVIDUAL HEDGING TRANSACTIONS
- CAN BE DIFFICULT TO POINT TO INDIVIDUAL HEDGING
- AN ASSUMED HEDGING STRATEGY CAN BE CREATED FOR LITIGATION PURPOSES BY AN EXPERT

WHEN CONSIDERING DAMAGES IT IS IMPORTANT TO UNDERSTAND THE DIFFERENCE BETWEEN A HEDGE AND SPECULATION

- Hedging should reduce risk - speculation increases risk
- Hedging may become speculative if no longer against any underlying physical position rather than to manage risk or mitigation.
- Important to recognise whether hedging is actually speculative and in which case may not be allowable as part of damages .

Damages can comprise hedging losses rather than loss on the physical – a real life example

Cargo delayed by 3 months

Cargo sold for Platts less US\$ 2 per mt rather than Platts plus US\$8 per mt

Market moved up so cargo actually sold for more in AS IS than BUT FOR

But hedges lost money because of rolling hedge into forward month, basis risk from hedging with different tools, and volume of hedge imperfect

Claim for about US\$ 5 million on a 70kt cargo of fuel oil

Case settled just before coming to Singapore Court – hedging never been tested under Singapore Law

Basis risk – difference between movement in hedge and physical price

The background of the slide is a light gray gradient with several realistic water droplets of various sizes scattered across it. The droplets have highlights and shadows, giving them a three-dimensional appearance. The text is centered and presented in a clean, sans-serif font.

FINAL THOUGHT

SHOULD A COMMODITY TRADER, WHO NORMALLY HEDGES BUT CLAIMS THEY HAVE NOT ONCE A BREACH TAKES PLACE, BE DEEMED TO HAVE FAILED TO MITIGATE?

SHOULD DAMAGES BE REDUCED IN ACCORDANCE WITH A SIMULATED HEDGING STRATEGY?

CATHERINE JAGO IS AN ARBITRATOR AND EXPERT IN OIL TRADING, SHIPPING, PRICING AND HEDGING

- OVER 33 YEARS EXPERIENCE IN THE OIL INDUSTRY
- FELLOW OF THE CHARTERED INSTITUTE OF ARBITRATORS, MEMBER OF LMAA AND SCMA
 - ON ARBITRATORS PANEL FOR GCCIG (GENEVA)
- JUSTICE OF THE PEACE SINCE 1995 CHAIRMAN SINCE 2002
 - MEMBER OF ENERGY INSTITUTE

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- GIVEN EVIDENCE ON MANY OCCASIONS IN HIGH COURT AND ARBITRATION PROCEEDINGS AND AVAILABLE AS AN ARBITRATOR
- BACKGROUND IN OIL TRADING, OPERATIONS, JOURNALISM, BROKING, MANAGEMENT CONSULTING, CREDIT CONTROL, ADVISED ON TRADING STRATEGY, RE-ORGANISATION, PERFORMANCE IMPROVEMENT
- PRAISED BY SOLICITORS, BARRISTERS, CLIENTS AND JUDGES ALIKE FOR HER INDEPENDENCE, INTELLIGENCE AND FAIR-MINDEDNESS
- AUTHOR OF "GUIDE TO TRADING OIL PRODUCTS" AND CONTRIBUTOR OF CHAPTERS TO "THE OIL TRADING MANUAL" AND "OIL AND GAS TRADING"

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MANY THANKS FOR YOUR ATTENTION.

FEEL FREE TO CONTACT ME FOR MORE
INFORMATION

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